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<u>TO: ALL BANKS, DISCOUNT HOUSES AND THEIR EXTERNAL AUDITORS</u>

<u>THE CONCEPT, USE AND TREATMENT OF BANKERS' ACCEPTANCES [BAs] AND COMMPERCIAL PAPERS [CPs]</u>

1. A recent survey conducted by the regulatory authorities revealed that there had been no proper understanding, use, and reporting of BAs and CPs among most banks. In many cases, the documentations and reporting of such transactions were not only inappropriate but also misleading.

2. In order to ensure standardized and uniform practice as well as correct reporting, it has now become necessary to issue the following guidelines which take immediate effect.

3.1 Working definitions of BA and a CP are given below for guidance.

3.1[a](i) A <u>Banker's Acceptance</u> is a draft drawn on and accepted by a bank, unconditionally ordering payment of a certain sum of money at a specified time in the future to the order of a designated party. Since the instrument is negotiable, title to it is transferred by endorsement. It is a unique instrument in that it is marketable and thereby allows a bank to finance its customers without necessarily utilising its loanable funds. Instead, funds are provided by investors who are willing to purchase these obligations on a discounted basis.

(ii) A <u>Commercial Paper</u> is an unconditional promise by a person to pay to or to the order of another person a certain sum at a future date. Such an instrument may or may not carry the bank's guarantee. But where the bank guarantees the CP to make it more marketable in the money market, the instrument acquires the force of a BA and the bank incurs a contingent liability.

3.2 The following essential features must be present for any facility to qualify as a BA or CP.

(a) **BANKERS' ACCEPTANCES**

i) Every Bankers Acceptance must have an underlying trade transaction for which the bank should hold the title documents to the merchandise as collateral for the acceptance. These documents should be available for Examiners' scrutiny.

ii) An acceptance must be represented by a physical instrument in the form of a draft signed by the drawer and accepted by the bank. All BAs must be properly executed by the bank by affixing its 'ACCEPTED' stamp, signature and date on the face of the bill. These shall be made available for the Examiners' scrutiny.

iii) The bank should have a signed agreement for each acceptance it creates.

iv) By accepting the draft, the bank formally undertakes an obligation to pay the stated sum on the due date. Since the draft is a negotiable instrument and may be transferred by endorsement, the bank is obligated to pay the holder of the instrument on, but not before, the maturity date. The bank is therefore the primary obligor.

v) The bank may discount its acceptance or sell same to an investor at a discount.

vi) Funds collected from customers for investment in BAs should be treated as deposits until such a time they are actually invested in the desired instrument.

vii) Investors in BAs should be made aware of the identity of the issuer of the instruments.

viii) Any bank which, after acceptance, discounts the bill by disbursing its own funds shall report the transaction on-balance sheet as a loan.

ix) The bank may charge an appropriate fee for accepting a bill.

x) The tenor of BAs shall not exceed 180 days [including renewals if necessary] excluding days of grace beyond which the facility should transform to a loan (on balance sheet).

(b) **COMMERCIAL PAPERS**

i) As with BAs, funds collected from customers for investment in CPs should be treated as deposits until such funds are invested in the instruments. Investors in CPs should also be made aware of the identity of the issuer of the instruments.

ii) CPs should only be guaranteed and not accepted since the intermediating bank is only a secondary obligor

iii) When a bank invests in a CP by disbursing its own funds, the transaction should be reported on balance sheet and treated as a loan. However, if the bank merely guarantees the instrument, it should be shown off-balance sheet as a contingent liability.

iv) Where a CP which had been guaranteed by a bank crystallizes by virtue of the inability of the issuer to pay on maturity, the bank as the secondary obligor is bound to redeem its guarantee by disbursing funds to the beneficiary. The transaction should then be reported on balance sheet as a loan.

v) The bank may charge an appropriate commission in line with the Bankers' Tariff for providing the guarantee.

4(i) All transactions in BAs and CPs in which a bank merely adds its name to enhance marketability of the instrument [without disbursement of funds) should be reported off balance sheet as a contingent liability. On the other hand, if a bank invests directly in these instruments by disbursing its own funds, the transactions should be reported on balance sheet and these become part of the bank's credit portfolio.

4(ii) In relation to Section 20(1)(a) of BOFID, 1991, as amended, $33^{1/3}$% of a bank's Off-Balance Sheet BAs and guaranteed CPs will be applied in determining the bank's statutory lending limit to a single obligor, as defined in that Section.

4(iii) A bank's total exposure on BAs and guaranteed CPs should not be more than 150% of its shareholders' funds unimpaired by losses.

5 Banks and Discount Houses are to note that the inappropriate use of the terms BAs and CPs will no longer be tolerated. Furthermore, any improper reporting of these and similar transactions will be regarded as rendition of false returns and shall attract appropriate sanctions.

6 This circular may be reviewed from time to time in the light of experience.

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